

# Reserves - What are they and what do you do with them?

Following the major changes to superannuation legislation in 2007, the attraction of reserves in SMSFs diminished. Industry innovation and a response to further legislation and regulatory interpretation has, however, seen somewhat of a resurgence in the use of reserves in SMSFs.

**This paper considers what is a reserve in the SMSF context, the types of reserves an SMSF may use and some benefits and complications of doing so.**

## SMSFs and reserves

For practical purposes, a reserve can effectively be considered to be another member account within an SMSF.

Like a member's accumulation account, it will hold a balance and generally share in a portion of income and expenses of the fund.

SMSFs trustees are permitted, under SIS legislation, to hold funds in one or more reserves, provided that:

- the trust deed of the fund **does not prohibit** the use of reserves (SIS Act s 115); and
- the trustee has a **strategy** to deal with the reserves (s 52B(2)(g)).

Amounts allocated from fund reserves may be counted towards the contributions caps that apply to individual fund members - this will be considered in more detail below.

## Reserving strategy

It is important to note that if the fund maintains any reserves, the trustee is required to formulate and give effect to a strategy for their prudential management.

The strategy for fund reserves must be consistent with the SMSF's investment strategy and its capacity to discharge its liabilities (whether actual or contingent) as and when they fall due.

## Adding to reserves

Generally, SMSF reserves can be increased in four ways, by way of:

- contributions allocated to a contributions reserve;
- returns from fund investments being credited to a reserve;
- returns on investments already held in reserves; or
- proceeds of insurance policies being paid to a reserve.

### Note

The proportion of income and capital gains attributed by an SMSF to reserve accounts will be subject to tax at normal rates, even if all other income of the fund is exempt from tax under the exempt current pension income provisions.

## ATO guidance

The ATO, in a recent Private Binding Ruling (# 1012758141685), provided guidance on 2 questions raised in respect to reserves, namely:

- Can the trustee of an SMSF pay an amount from a reserve directly to a member of the fund

in satisfaction of the required minimum pension payment? and

- Are the amounts allocated from the reserve to a member of an SMSF treated as concessional contributions ....?

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*The trust deed of the SMSF must not prohibit the use of reserves.*

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In response, the ATO advised:

- No - an amount cannot be allocated from the reserve to the member's pension account, nor can it be paid directly from the reserve to the member in satisfaction of the minimum account based pension requirements.
- No, provided the allocation ... does not exceed 5% of the value of the member's interest in the SMSF at the time of allocation.

Other ATO guidance, in the form of Taxation Determination TD 2013/22, and Interpretative Decisions ID 2015/21 and ID 2015/22, will be covered below.

Current as at 25 August 2015

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# Reserves - What are they and what do you do with them?

## Types of SMSF reserves

A number of different types of reserving arrangements that could potentially arise in SMSFs are discussed briefly below.

### Contributions reserve

Generally, contributions which are paid to a fund in respect of a member must be allocated by the trustee to the member's account by the 28<sup>th</sup> day of the month following receipt by the fund.

Until allocated, the contributions may be held in a reserve. This is particularly relevant when contributions are received by the SMSF in the month of June, but are intended to be for the next financial year (i.e. July).

The contributions may be held in a reserve, and allocated by the trustee to the member's account before 28 July.

Incidentally, the ATO does not use the word 'reserve' in describing this scenario, instead using the term 'unallocated contributions account'.

However, as the SIS Act refers to 'reserves' and the provisions contained in SMSF trust deeds tend to flow from that, Topdocs suggests it is better practice to consider the account as a reserve and prepare documentation accordingly.

That is particularly relevant when considering that any objections to an assessment the ATO may issue for excess contributions will require production of the appropriate documentation to support the objection.

To potentially remove the need for the ATO to issue excess concessional contribution assessments, and then

consider an objection to the assessment, the ATO has released a form 'Request to adjust concessional contributions' so as to identify the fact that contributions made in one year are to be allocated in the following year.

Despite that positive action, Topdocs recommends that documents detailing the decision to allocate the contribution in the following year and to establish a contributions reserve, be prepared and retained as part of the fund documentation.

#### Note

Topdocs provides a range of documents including resolutions in respect of unallocated contributions and the establishment of a contributions reserve.

### Anti-Detriment reserve

An anti-detriment reserve is established to fund the 'increased amount' which may be paid to certain dependants of a deceased member, as an increase to the lump sum superannuation death benefits, under the anti-detriment provisions.

Such a reserve is one of the major types referred to at the heading of this paper, which has seen its popularity curtailed following the 2007 legislative changes.

The reason for that fall in popularity is because payments from the reserve, generally being of significant amounts, will most likely be included in the excess contribution caps and, potentially, incur penalty tax.

### Investment reserve

Investment reserves, sometimes also referred to as income equalisation or smoothing reserves, are reserves

used for the purpose of determining the allocation of investment earnings to member accounts.

In practice, this generally involves the fund allocating a certain amount of annual earnings (in years of relatively high investment returns) to an investment reserve account, to be accessed in future years of lower investment returns.

#### Example - Investment reserve

Jane and Bob have an SMSF in which, during a particular financial year, the fund achieved an investment return of 15%. Their trust deed provides for the 'smoothing' of returns to limit the probability of a negative return being declared in any financial year.

Rather than crediting the entire 15% return to their individual member accounts in that year, the trustee decided (in accordance with the fund's trust deed and reserving strategy) to credit 12% to member accounts and allocate the remaining 3% to the fund's 'investment reserve account'.

In the following financial year, the fund achieved an investment return of 8%. The trustee decided to credit 10% to member accounts, effectively drawing 2% of the previous year's 3% allocation, thereby 'smoothing' the return for those two years.

### Insurance reserve

The purpose of an insurance reserve is to pay premiums on insurance covering the life and/or disability of one or more members of an SMSF,

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# Reserves - What are they and what do you do with them?

and to receive the proceeds of a policy in the event of a claim.

The ATO has stated that, in its view, the proceeds of an insurance policy should be added to the account from which the premiums were paid, "notwithstanding that it is not possible to say that the member will have an interest in the policy, it being owned by the trustee" (*ATO National Tax Liaison Group (NTLG) Superannuation Technical Sub-Group, Sept. 2009*).

Usually, insurance premiums are paid from the accumulation account of the member on whose life the cover is held and, in the event of a claim, the proceeds are paid to the member's account and, in many instances, paid out of the fund.

In instances where it is preferable for the insurance proceeds to remain in the SMSF, ensuring the proceeds of any claim are directed to an insurance reserve will enable the funds to remain within the SMSF.

As the funds held in the reserve do not belong to a particular member, the trustee is not required to pay that money as member benefits and can apply them for other purposes, such as clearing a loan under a limited recourse borrowing arrangement.

## Example - Insurance reserve

Danny is considering the purchase of a property by his SMSF under a limited recourse borrowing arrangement.

As Danny is the sole member of his SMSF and, following his death, his benefits will need to be paid to his

adult children, he realises the SMSF will be in a vulnerable position with a 'lumpy asset' and possibly a large amount of debt.

To avoid the need for a fire sale of the property, Danny has his SMSF take out insurance cover on his life. Rather than paying the premiums from his member account, Danny decides to create an insurance reserve in his SMSF, from which the premiums will be paid.

The trust deed permits the trustee to operate one or more reserves.

If Danny passes away:

- in accordance with the ATO position, the proceeds of the life policy will be added to the insurance reserve;
- Danny's benefit in the SMSF will need to be paid out to his dependants or to his estate;
- the cash from the insurance proceeds can be used to pay the benefit;
- the property can remain in the SMSF, avoiding the need for an urgent sale of the property;
- if they wish, the adult children can become members of the SMSF; and
- if so, the value of the insurance reserve can be gradually transferred to the members over time.

## Note

There are limitations on the types of insurance an SMSF may hold, and the purpose for which the cover is held, which is outside the scope of this article.

## Defined benefit reserve

Defined benefit reserves, also known as solvency reserves, can arise for SMSFs if established as defined benefit funds prior to 12 May 2004:

- to support the payment of fixed term or lifetime pensions; and/or
- to support the funding of traditional defined benefit arrangements.

In its Interpretative Decision, ID 2015/22, the ATO considered the scenario of funds supporting:

- a defined benefit pension being applied to commence a market linked pension; and
- a pension reserve being applied to commence an account based pension.

It determined that the amount allocated from the pension reserve (i.e. to the account based pension) would be included under the member's concessional contributions cap.

## Forfeited benefit reserve

Forfeited benefit reserves hold amounts forfeited to the fund from member accounts.

## Note

Due to the vesting requirements under SIS, the use and existence of a forfeited benefit reserve would be very rare.

## Allocation of reserves

Amounts held in reserves will generally be dealt with (i.e. allocated) in accordance with the provisions of the fund's trust deed.

Generally, the funds allocated from a reserve will be measured, with

# Reserves - What are they and what do you do with them?

other contributions, against a recipient's concessional contributions cap. This will be considered further below.

Where reserves exist and there are no remaining members, the reserves will be dealt with according to the 'wind up' provisions contained in the fund's trust deed.

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*... amounts allocated to an SMSF member from fund reserves may be counted against the concessional contributions cap.*

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## Concessional contributions cap

In certain circumstances, amounts allocated to an SMSF member from fund reserves may be counted against the concessional contributions cap. However, this will not generally occur if:

- the amount is less than 5% of the value of the member's interest in the fund and is allocated in a fair and reasonable manner for:
  - every member of the fund; or
  - every member within a class of members who get the reserve allocation; or
- the amount is used solely to discharge a current pension liability at that time and allocated to:

- satisfy an existing pension liability within the fund;
- commence a new pension (on commutation and rollover of an existing pension); or
- pay a superannuation death benefit.

### Note

The above appears to contradict the answers contained in the Private Binding Ruling mentioned previously. However, the exception mentioned above relates to the funding of defined benefit pensions, for example when the actuary calculates a shortfall in meeting the solvency requirements and directs the trustee to transfer funds from a solvency reserve to rectify the position.

The ATO, in Taxation Determination TD 2013/22, rules that the amount of a contribution made to a super fund in a particular year (year 1) and allocated to a member the following year (year 2) will be counted against the member's contributions cap in year 2.

Also, in its Interpretative Decision, ID 2015/21, the ATO covered the issue of payments from a self-insurance reserve and whether such payments were measured against the recipient's concessional contributions cap, and determined that they would be measured against that cap.

## Reserving within funds

Managing of reserves is an important operational aspect of SMSFs.

Where reserving within an SMSF is used, careful attention is required in relation to the trust deed provisions:

- ensuring the trust deed does not prohibit (or, preferably in our view, actually permits) the use of reserves; and
- governing the types of reserves permitted; and
- when and how the reserves will be created, managed and used.

### Note

It is important to consider the overall consequences of having a reserving policy, with regard to the members' stated needs and objectives for the fund.

## More information

Should you have any queries or require more information, please contact the team at Topdocs on 1300 659 242.

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